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THE IMPACT OF INFLATION ON THE
DIRECTORATE FOR ADMINISTRATION

Although the Directorate contains 9 basic support activities, the problem of assessing the impact of inflation can be focused quite sharply. The bulk of the non-personnel expenditures are concentrated in communications, logistics, and computer services. When these expenditures are removed from the total budget of the Directorate, 88 percent of the remainder is for personal services. Since 1967, the index of costs of personal services has risen 71 percent. Until 1974, the costs of goods and services rose less rapidly but during 1974 this situation reversed.* During that year prices of goods and services rose 23 percent, impacting severely on Communications, Logistics, and the maintenance costs [redacted]. The impact on OJCS was somewhat less severe. With budgetary and cost pressures intensifying during 1973 and 1974, the Offices of the Directorate were subjected then to sharper personnel reductions than in previous years.

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If inflation continues, and the judgment is that it will over the long run, it will become more difficult for the Offices to absorb increased costs while maintaining essential services. In the past, the support activities were cut back as many of the programs they supported were cut back. Thus reduced hiring lightened the load on Personnel and Training; cutbacks in programs in Southeast Asia reduced the burden on Logistics. To a point, a lesser quality of service could be accepted; maintenance on buildings and grounds could be reduced; some employee services could be performed with fewer staff (and longer waits). But as the Agency approaches the point where it has been reduced to core activities and core staff, many

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of the support functions will rise in importance. When replacements are hired for all personnel losses, the level of recruiting will increase. Training activities will increase in response to increased hiring and growing emphasis on career development. Deferred maintenance expenses will reach the point where they are no longer deferrable. There will be tradeoffs between reduced overseas staffing and increased costs of travel and communications.

What is the likelihood that inflation will continue? Though the pace of inflation now seems to be easing, some of the policies designed to end the recession now may sustain future inflation. We are already well into FY 1975 and significant rises in costs have already been recorded; therefore, it would seem that the average increase in costs of goods and services will be a minimum of 7 to 9 percent for the year.**

The annualization of the October 1974 Pay Act will produce a modest increase in the index for personal services. For the coming fiscal year, there is growing agreement that the pace of inflation will be between 7 and 11 percent; higher for non-compensation components of the budget and lesser for personal services. While such magnitudes are modest in terms of the recent pace of inflation, a 7 percent increase in costs would yet amount to more than 12 million dollars for the Directorate. The chances of offsetting such an increase through measures to increase efficiency and productivity are nil; historically such measures could offset only 2 to 3 percent rises in costs.

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When the annual impact of inflation is the same as a cut in budget, it is a matter of management concern to measure and

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monitor changing prices. Though we read everywhere about inflation, people often have different understandings about the terms used; so some definition of terms is in order. The increase in prices of goods and services, to the extent it is not related to significant changes in the quality of product, is inflation. It is measured in indexes that indicate, usually on a weighted basis, how much prices for selected items have increased relative to a base year. If one wishes to convert the value of current dollars to the value of the dollar in a base year, that is, to remove the inflation, he uses a deflator. The form of deflator used in this study is the reciprocal of the price index. The price index itself measures how much prices have increased; the reciprocal of the index measures how much the purchasing power of the dollar has shrunk.

When we measure the inputs of intelligence in constant (base year) dollars, we have a more valid measure of real change in the volume of inputs available to programs than when we rely on budget dollars, because the price variable has been removed. A manager has a better handle on what has been happening to his resource availability over the years (that is, whether he has more or less real purchasing power). However, it should be stressed that data on resource availability measured in constant dollars are not data expressing outputs. The significance of this is that the output trend can differ from the input trend to the extent that productivity is an offset. In other words, if purchasing power declines 3 percent a year, output may remain constant if productivity of resources increases an equivalent amount.

The deflators applicable to the Agency are given in the Table. They are expressed as separate deflators, one for compensation and one for goods and services. Developed by the Office of Economic Research at the request

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II. The DD/A Dollar Shrinks -- Background

Although the Directorate contains 9 basic support activities, the problem of assessing the impact of inflation can be focused quite sharply. The bulk of the non-personnel expenditures are concentrated in communications, logistics, and computer services. When these expenditures are removed from the total budget of the Directorate, 88 percent of the remainder is for personal services. Since 1967, the index of costs of personal services has risen 71 percent. Until 1974, the costs of goods and services rose less rapidly but during 1974 this situation reversed.*

During that year prices of goods and services rose 23 percent, impacting severely on Communications, Logistics, and the maintenance costs [REDACTED]. The impact on OJCS was somewhat less severe. To illustrate the recent price increases -- the cost of electric power (per KWH) increased as much as 50 percent during 1973 and 1974, gasoline -- 132 percent, fuel oil -- 158 percent, air travel -- more than 25 percent, paper -- more than 50 percent, chemicals -- 25 percent, film -- 29 percent, wood and lumber -- more than 50 percent, military air cargo transport -- 81 percent (and another 20 percent

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during 1975), postal rates -- 15 percent, and construction -- 20 to 30 percent. Inflation in the United States did not occur in a vacuum, the same period witnessed a major increase in the cost of supporting an employee overseas, which rose from \$16,115 in 1972 to \$21,425 in 1974 and \$25,818 in 1975 (or 60 percent in three years). With budgetary and cost pressures intensifying during 1973 and 1974, the Offices of the Directorate were subjected then to sharper personnel reductions than in previous years.

If inflation continues, and the judgment is that it will over the long run, it will become more difficult for the Offices to absorb increased costs while maintaining essential services. In the past, the support activities were cut back as many of the programs they supported were cut back. Thus reduced hiring lightened the load on Personnel and Training; cutbacks in programs in Southeast Asia reduced the burden on Logistics. To a point, a lesser quality of service could be accepted; maintenance on buildings and grounds could be reduced; some employee services could be performed with fewer staff (and longer waits). But as the Agency approaches the point where it has been reduced to core activities

and core staff, many of the support functions will rise in importance. When replacements are hired for all personnel losses, the level of recruiting will increase. Training activities will increase in response to increased hiring and growing emphasis on career development. Deferred maintenance expenses will reach the point where they are no longer deferrable. There will be tradeoffs between reduced overseas staffing and increased costs of travel and communications.

25X9 Reductions of personnel in the Directorate have kept pace with overall reductions in the Agency. The ratio of Directorate staff personnel to the Agency total, which was Program estimates indicate that the ratio will not increase. ?

What is the likelihood that inflation will continue? Though the pace of inflation now seems to be easing, some of the policies designed to end the recession now may sustain future inflation. We are already well into FY 1975 and significant rises in costs have already been recorded; therefore, it would seem that the average increase in costs of goods and services will be a minimum of 7 to 9 percent for the year.**

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III. The Offices Speak About Inflation

In the preparation of this study, each Office was asked to survey the impact of inflation on its own operations. They have done so and further have provided information about their own efforts to cope with inflation. The details are provided in the Annexes. From their accounts, it is apparent that, although the Directorate has done a great deal to improve productivity and to conserve on resource use, the accelerated inflation of recent years has begun to erode the ability of many Offices to respond in the desired fashion to requirements levied on them by operating components. Recognizing this, the Offices support the Directorate's effort to develop a more direct approach to the problem of dealing with persistent and rapid inflation.

A. Office of Communications

In terms of the present aggregation of activities, the Office's buying power remained fairly level from FY 1967 through FY 1971, rose in FY 1972, and then declined considerably to its present level. The estimated increase in overall productivity was 50 percent

25X9 and was based upon automation and technological advances. An immediate consequence of productivity increase was the deletion of [] formerly devoted solely to the operation of the communications network -- these do not include functions transferred outside the Office. The closure of three major relay stations contributed both positions and other cost savings. Despite the good record of productivity increases, the rapid escalation of inflation since FY 1973 has created serious problems for cost-conscious management and it is apparent that price increases are now outstripping any prospect of cost savings.

B. Office of Finance

The share of personal services in the budget is 95 percent, so the Office has been affected by the 71 percent increase in average pay since FY 1967. It has striven for productivity offsets and expects an employment level in FY 1977 that is 16 percent below that of FY 1967. Efforts to do more with fewer have been impeded by new and often unanticipated requirements, such as the retroactive pay adjustments and FLSA procedures. Manpower limitations are having adverse impact such as causing delay in the implementation of work-saving

computer systems, backlogging of claims and vendor invoices, and reduction of financial support in the field.

C. Office of Joint Computer Support

25X9 The of the Office's budget that is for equipment-related expenses is not as vulnerable to inflation as might be expected, because the computer industry has been able to tap advanced science and technology to improve the capacity and functioning of computers and related equipment while reducing the cost per unit of capacity or function. The management problem relates to the demand or requirements side rather than to the cost side. Indeed, the efforts of other Offices to reduce manpower requirements can, and do, increase the requirements levied on this Office. Approximately one third of the Office's budget is for personal services and this portion is subject to pay escalation and management pressures to resist staff increases. Contract services account for 15 percent of the budget, and here the cost of a manyear of contractor support has increased 83 percent since FY 1967.

D. Office of Logistics

During the last two years, unparalleled cost increases for consumables and other essential supplies have occurred, and the necessary budgetary relief has been provided. Consuming offices and the Office of Logistics have had active programs to seek economies where feasible. The Office is hopeful that the worst is over and that prices will tend to level out, although at a high level. As examples of what has happened to prices, the cost of paper used in the printing operation increased 54 percent during FY 1974 in comparison to FY 1973 and another 10 percent during FY 1975. Other areas where significant increases were recorded included: film, chemicals, packing and crating supplies, cargo shipments via military aircraft, postage rates, operation and purchase of motor vehicles, and service contracts. Some of the programs to offset higher costs included: a campaign for paper conservation, stocking a smaller selection of office supplies and selecting cheaper items where feasible, increased use of sea transport rather than military air, consolidation of Agency mail and courier operations and reduced reliance on the Postal Service, fuel conservation, utilization of excess vehicles rather

than purchase of new ones, and efforts to increase the productivity of Logistics personnel.

E. Office of Medical Services

Generally the impact of inflation on this Office is on personnel costs and these have been met by the budget without large reductions of staff personnel. Some requests for new services, such as human factors research, could not be satisfied. Of greatest concern is the ceiling on supergrade pay which threatens to affect recruitment of physicians.

F. Office of Personnel

As 90 percent of this Office's budget is for personal services, the major offset to higher pay costs has been a 20 percent reduction of ceiling since FY 1967. In the future, it will be difficult to implement additional cuts without impairing vital functions. Other areas affected by cost increases are the invitee travel program, and the Overseas Medical Program administered by the Office of Personnel.

G. Office of Security

The Office of Security has only limited flexibility to deal with higher costs. Since FY 1967, it has reduced

staff employment by 24 percent. Forty six percent of its budget for goods and services; of this half is for guard salaries reimbursed to the General Service Administration. Budgetary pressure has tended to lead to the deferral of procurement of needed audio counter-measure and physical security equipment, to the point that the Office considers that the Agency is now several years behind where it should be. The effects of inflation on the badge machine program which has seen a doubling of original price estimates are placing this much-needed program in serious jeopardy.

H. Office of Training

Until recently, productivity increases in training operations have provided major offsets to the higher costs of internal training. The Office has reduced its personnel (staff and contract) by 29 percent since June 1968 while the number of student days has increased dramatically. As OTR has shrunk, Agency expenditures for external training have trebled since FY 1967 and the costs per student have increased by two thirds during the last two years.

25X1A [REDACTED] has been particularly exposed to the consequences of inflation. The sudden increases in the costs of fuel and utilities have led to requests for additional funding, while the new

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The Center is another example of an installation encountering the consequences of rapid rises in costs for fuel, utilities, and maintenance. In spite of on-going conservation programs that have reduced fuel oil consumption by 26 percent since 1972 and electricity by 16 percent, the Center currently faces a shortfall of funds totalling \$150,000.

V. Current Guidelines and Practice

Long established Office of Management and Budget guidelines prescribe generally that price levels "will be the same during the budget year as at the time the estimates are prepared" (OMB Circular A-11). The only stated exceptions to this guideline applicable to the Agency are that a) increases for average personnel compensation for the budget year from all causes "should be no more than 1 percent unless specifically justified" and b) "wage board increases expected to be granted during the remainder of the current year" may be extended at the higher rate during the budget year.

Agency Program Calls and Budget Calls as long as can be remembered have either specifically expressed the "no inflation" concept contained in OMB Circular A-11 or have simply referred to the circular in general as the guideline for preparing estimates. Informal guidance by Agency officials from time to time may have given encouragement to the estimators at office levels to provide for some anticipated inflation but the extent of such informal guidelines if existent is unknown.

A poll of Administration Directorate Offices revealed that where possible and practical most are battling inflation in two general ways:

First, in estimating future projects at current dollar rates, most Offices attempt to take into consideration anticipated future costs. Of course in some instances we are constrained to use available price lists, but when we reach a situation where specific costs are unknown it can be assumed that the estimative process consciously or unconsciously takes into consideration cost increases, some of which will be due to inflation. Admittedly this technique is imprecise because of the fluid nature of the economy, but it does serve as a hedge.

A second technique is to observe increases in the commercial prices of goods and services. As our suppliers increase their prices to commercial consumers, we can safely assume that similar increases will be passed on to the government. In preparing office budget estimates or operating budgets, these increases are included to ^{cover} ~~hedged~~ costs that will be incurred in the near future. While this is not done widely, some Offices occasionally are able to monitor and to budget for significant increases in major budget items when quoted by manufacturers.

We can assume that these practices have only recently caused changes of any significance in the budget process and are one way of protecting Agency interests. Caution must be exercised in using compensating measures since changes in the economy could cause over-budgeting and a year-end surplus. It is also necessary to consider counter-trends in consumption. Inflation fighting campaigns have the effect of reducing demand for inflation intensive products, encouraging employees to accept and use less expensive substitute products and decreasing demand for goods and services in general. A combination of over-budgeting for inflation and decreased consumption could seriously hamper an effort to present a realistic budget and might even affect the credibility of future budget presentations.

Other government agencies generally abide by the ~~same~~ A-11 groundrules. One notable exception, however, is in the Department of Defense. For the past several years, an exemption to the pricing guidelines has been granted to DoD to include an allowance for price escalation in its RDT&E, Procurement and Military construction appropriation estimates for major weapons systems and

military construction projects. This exemption has recently been extended to permit Defense to also include an allowance for price escalation in the Procurement

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Management and Budget has endorsed this exemption to the general rule of "no inflation" and of course would have to approve any additional exemptions that might be granted in the future.

The rate of inflation allowed in the Defense Department budgets is a subject of current debate and deliberation. The previously approved 3 percent to 5 percent inflation rate is recognized as significantly inadequate in the light of today's escalation which promises to continue well into the future, ~~at least through FY 1970~~. Defense officials feel that realism in cost estimating in the military budget is essential if we are to accurately portray our ~~new~~ defense posture in presenting the President's Budget to Congress. Underestimating the rate of inflation, while better than nothing, causes proportionate and measurable falsification of what the bucks will really buy when the budget year as well as the out-year programs are actually executed.

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VI. Alternatives in Dealing with the Impact of Inflation

For that important portion of the budget that goes for personal services, there is a fair measure of ad hoc protection against inflation through the periodic add-on bottom line entries to cover the costs of new Pay ~~Acts~~ *increases*. To the extent that the Agency is forced to absorb some of the ~~pay~~ *pay* increases, there may be, and usually is, pressure to reduce employment in support activities and in some lower priority operating activities. This is feasible if it is linked to expected increases in productivity or to the pruning of functions or services no longer required. Across-the-board cuts not related to productivity gains tend to be counter-productive, and deep cuts can be disruptive to personal ^{net} systems over ~~both~~ the short run, through impact on morale, and the long run, through distortions in structure (age, grade, and occupational profiles).

The impact of inflation may be particularly severe for those offices ^{which} ~~that~~ make substantial expenditures for goods and services -- namely, ^{the offices} Communications, Logistics, and Joint Computer ^{Support} ~~Services~~. For each of these Offices,

key policy decisions materially affect ~~their~~ requirements and, hence, ~~their~~ budget levels. ^{However,} ~~but~~ once these decisions have been made by the appropriate authority, the Offices face ~~a~~ severe problemⁱⁿ ~~of~~ protecting the purchasing power of their budgets so that they can meet ~~their~~ approved objectives.

Some examples of key decisions that shape requirements are, for Communications, contingency requirements for redundant HF communications, the continuing use of small communications stations, and the provision of secure voice capability. Some key decisions affecting Logistics are: requirements for contingency supplies; the continuing use of rented and dispersed office space; and the continuing postponement of new construction in the face of growing construction costs. Some of the key decisions for Joint Computer Services are: consolidation of computer services, the increasing requirement for on-line capabilities and more terminals, the need for larger memories, and the growing demand for user-oriented programs.

Continuing inflation is likely to force reappraisal of some ~~of these~~ key decisions. Thus, for example, higher costs for utilities, vehicle use, and consumption of personnel time in commuting during working hours may make space consolidation of greater priority. Higher overseas

costs may force reexamination of the Agency's dispersed field deployment. The increased costs of holding inventories ^{will} ~~may~~ force a purging of obsolete items from the shelves.

Such reexamination of key decisions would have major impact on support costs. But once a requirement has been revalidated, management has a continuing problem ⁱⁿ ~~to~~ assuring that the desired level of support is maintained in the face of rising costs that eat away purchasing power.

The options appear to be few, consisting of the following, either singly or in combination:

1. As a matter of Agency policy, provide each office a lump sum entry for inflation under such controls that budgetary discipline is maintained.
2. Budget for inflation, under appropriate guidelines, in each line item where inflation is an appropriate consideration.
3. Use the Agency's contingency reserve for supplementary allotments to cover major unbudgeted cost increases.

4. Budget for inflation implicitly so that enough budgetary authority is provided to cover inflation but the explicit justification is attributed to requirements.

These options can be summarized on the basis of the discussion in the S&T paper.

If the Agency does not follow the across-the-board approach of option one, which is the approach followed in the Department of Defense and ~~was followed in~~ the former Atomic Energy Commission, it would seem possible to develop an approach for the Directorate that would be relatively selective, encouraging productivity gains and conservation while protecting the activities most vulnerable to the erosion of inflation. The following recommendations would establish such an approach.

Recommendations:

1. Until such time as inflation does not exceed the pace of productivity gains, the Office of Communications, Logistics, and Joint Computer Services should be given a bottom line allotment to cover inflation of non-personnel costs. They should be accountable for the allocation of this sum to specific projects and line items. Any surplus should revert to the DDA for yearend reallocation or for

turnback to the Comptroller, as appropriate. Other offices may be given specific authority to include inflationary allowances for specified purposes, such as the maintenance of facilities or the costs of invitee travel.

2. Each office should develop a productivity plan with the objective of achieving specified economies of personnel, goods, and services.

3. The DDA Plans Staff, in cooperation with appropriate offices, should review key management decisions that generate requirements on the Directorate. ~~for the~~ *The* purpose of this review ~~should~~ be the identification of alternative courses of action that would permit substantial economies.

4. The Directorate should review office manpower plans to assure that personnel reductions are appropriately distributed by grade and that grade creep is controlled.

5. Offices that make substantial expenditures for equipment or for maintenance of installations should be encouraged to develop capital budgeting. This would support more realistic assessment of the consequences of postponing needed expenditures and would help assure

that longer range considerations are interjected into annual program review.